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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series

Renewed Currency Turmoil

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1973

INTELLIGENCE MEMORANDUM

RENEWED CURRENCY TURMOIL

SUMMARY AND CONCLUSIONS

1. International currency markets are in the midst of another crisis. At the market close on 6 February, the dollar was at or near the floor against most major currencies. Foreign central bank interventions in support of the dollar have totaled almost US $4 billion since 29 January. Most of this was provided by West Germany. Traders apparently are not convinced by recently strengthened German capital controls or by German protestations that they will defend the Deutschemark parity.

2. The most recent run on the dollar developed after the Italian and Swiss decisions to modify their exchange markets. On 22 January, to reduce its net deficit on capital account, Italy introduced a two-tier foreign exchange system similar to that already used by France and Belgium. The Italian move resulted in an increased capital inflow into Switzerland. Bern, in turn, floated the Swiss franc on 23 January, although the Swiss National Bank had purchased only about $200 million in support operations.

3. Reports of a record US trade deficit and record German and Japanese trade surpluses increased currency market uncertainties. The 1972 US deficit of $6.8 billion was more than 2-1/2 times the previous (1971) record, and most analysts predict a deficit of more than $4 billion in 1973. The West German and Japanese surpluses were $8.3 billion and $9.0 billion, respectively. The money market apparently is not willing to accept the repeated explanations that lags associated with exchange rate adjustment and cyclical factors are the primary factors behind the growing trade imbalance.

4. The currency markets are likely to experience continued periodic upheavals. Each unfavorable trade balance report is a potentially unsettling

Note: This memorandum was prepared by the Office of Economic Research.

factor. With inflationary pressures increasing in Europe, changes in interest rates could also provoke speculative capital flows. Moreover, recent history suggests that nations will act rapidly to protect what they conceive to be their national interest despite the impact on currency markets. Still, the fact that West Germany and Japan are willing to add substantially to their dollar holdings demonstrates a commitment to the principles of the Smithsonian agreement and may be enough to prevent a crisis of 1971 magnitude.

INTRODUCTION

5. International currency markets are now experiencing their second significant upheaval since the Smithsonian accord. The dollar came under concerted pressure in late January, following the Italian introduction of a two-tier foreign exchange system and the Swiss franc float. Most major foreign central banks have been forced to intervene to support the dollar, the first significant interventions since the British floated the pound last summer. This memorandum reviews and analyzes developments in the international financial markets through 6 February.

DISCUSSION

Background

6. The Smithsonian agreement in December 1971 produced an extensive realignment of world currencies. This followed a year of near-continuous uncertainty in international currency markets. The US dollar was devalued 7.9% relative to gold, while most other major currencies revalued relative to the dollar by amounts ranging from 7.5% in Italy to 16.9% in Japan. The agreement also provided for more flexible exchange rates; currencies are permitted to fluctuate up to 2.25% on either side of their new central rates rather than the 0.75% permitted under the old regime. These changes were designed primarily to help the US trade balance, to reverse the large dollar outflows, and to reduce speculation in the currency markets.

7. The agreement had less of an impact in financial markets than was anticipated, however.[1] In the early part of 1972, higher European and Japanese interest rates resulted in a continuing net outflow of US dollars.

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Although there was a small net inflow between mid-March and mid-June -- a period of relative exchange market stability -- these gains were more than wiped out in the five weeks after the attack on the British pound in June. Following the pound crisis, money managers took the attitude that the probability the dollar would weaken was much greater than the probability that it would strengthen. This attitude gave them little incentive to cash in foreign currency holdings for dollars.

8. Sterling and the Italian lira replaced the dollar as the weakest major currencies in the latter half of 1972. The pound depreciated from $2.58 before the float to a low of almost $2.32 in October before climbing back to about $2.35 at year's end. The pound's poor performance is explained by continuing labor problems in the United Kingdom and disappointing trade results. The pressure on the lira largely reflected capital outflows, which, in turn, resulted from political and social tensions as well as economic factors. The lira's weakness dragged other European Community (EC) currencies down relative to the dollar because the EC exchange rate program -- the "Snake in the Tunnel" -- had reduced the maximum deviation between member currencies to 2.25%.[2]

The Developing Crisis

The Lira's Defense

9. The beginning of the present currency turmoil can be traced to the Italian decision on 22 January to institute a two-tier exchange rate system. Because of the integration of world financial markets, this move, which was essentially motivated by uniquely Italian factors, had an effect not only in Italy but also in Switzerland and then in West German and other major currency markets. Continuing uncertainty over whether the Smithsonian exchange rate pattern would in fact restore international payments equilibrium further fueled money market speculation.

10. Rome's move to a two-tier system was designed to reduce Italy's continuing capita' outflow and protect the lira from growing speculation. Persistent economic stagnation, inflation -- aggravated slightly by introduction of the value added tax (VAT) -- and political uncertainty resulted in a massive short-term capital outflow. In the first half of the year, nearly $800 million left Italy in the form of illicit banknote exports to Switzerland. Although Rome essentially stopped converting Italian banknotes from abroad after the sterling float in June, the capital outflow persisted.

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11. The new Italian two-tier system is similar to those in Belgium and France. Most current account transactions -- primarily trade, shipping, and emigrants' remittances -- are handled in the commercial market, where the Bank of Italy supports the lira within the EC and Smithsonian currency limits. For most capital transactions, the exchange rate is determined by the interaction of supply and demand in the new financial tier of the market. The introduction of the new system resulted in a slight strengthening of the commercial lira and the discounting of the financial lira, but its overall impact on capital flows is uncertain.

The Swiss Franc's Float

12. Switzerland, which was the principal recipient of much of the legal and illegal capital outflow from Italy, floated its franc on 23 January, one day after the Italian move. Rome's establishment of a two-tier exchange system increased the demand for Swiss francs as did increased French purchases of gold coin in the Zurich market. The National Bank was forced to intervene in the exchange market and purchase about $200 million in foreign exchange in order to keep the franc within the Smithsonian bands. The decision to float was motivated by Bern's unwillingness to accumulate additional currency reserves, as internal Swiss inflation was blamed, in part, on the earlier reserve buildup.

13. Bern's decision to float has been criticized in some monetary circles. Many financial observers believe that the Swiss overreacted. They point out that the decision to float was made after relatively small dollar purchases by the central bank and that the volume of market activity in Swiss francs has been small. The Swiss franc has, however, appreciated relative to the dollar by 4% in the two weeks since the beginning of the float.

14. Bern insists that the float is temporary and vehemently denies that it heralds a revaluation. Indeed, an ad hoc float occurred last June and lasted only one week, at which time the franc was refixed at its previous parity.

Trade Problems

15. Unfavorable trade developments also have had a destabilizing influence on currency markets. Preliminary statistics indicate that the US trade deficit in 1972 will total about $6.8 billion, substantially more than expected and two and one-half times greater than the record 1971 deficit (see Table 1). The deficit would probably have been even larger were it not for the exceptional increase in US grain exports. The 1973 US trade account deficit is now forecast by the OECD to exceed $4.3 billion. The

Table 1

Actual and Forecast Trade Balances
For Selected OECD Countries

Million US $

	1971 Actual	1972 Forecast[a]	1972 Actual	1973 Forecast[b]
United States	-2,689	-4,300	-6,800	-4,300
Canada	2,543	1,500	1,500	1,700
Japan	7,787	9,200	9,000	8,250
France	1,105	1,300	1,100	2,000
Italy	328	1,350	700	900
United Kingdom	718	-850	-1,400	-2,500
West Germany	6,369	7,750	8,300	7,800

a. OECD Outlook, July 1972.
b. OECD Outlook, December 1972.

news of the large deficit came not long after the United States removed some controls on prices and wages, increasing foreign fears about renewed inflationary pressures.

16. The West German and Japanese trade surpluses were also substantially larger than in 1971. Bonn announced the trade surplus in 1972 was $8.3 billion, and the surplus is expected to be nearly as large this year. The Japanese surplus was a record $9.0 billion.

17. The unfavorable trade developments have been attributed to terms of trade and cyclical factors. Lags associated with the exchange rate adjustment have apparently had their expected perverse short-run impact on the trade balances. Differences in phase between the US, West European, and Japanese economies are also a factor. The money market, however, has begun to reject these explanations as the imbalances persist and even increase.

The Attack on the Mark

18. The Swiss decision to float the franc generated speculative pressures in other currency markets, particularly against the dollar and the mark. The dollar began to weaken and the mark strengthen with the Rome announcement, and these movements accelerated when the Swiss franc was

floated. Speculators then turned their attention to West Germany. Because the Swiss had capitulated after purchasing only $200 million in foreign exchange, speculators evidently believed the Bundesbank could be forced to float the mark, particularly as Germany was also suffering from domestic inflation.

19. Pressure on the mark became intense on 1-2 February. On 1 February the Bundesbank purchased about $220 million in foreign exchange in order to prevent the mark from breaking through its ceiling (see Table 2). In subsequent trading in New York, the mark did for a short

Table 2

Foreign Central Bank Dollar Intervention
1-3 February 1973

Million US $

	1 Feb	*2 Feb*	*3 Feb*[a]	*Total*
Total	**433**	**1,164**	**240**	**2,037**[b]
Belgium	50	"Above" 100	...	"Above" 150
Denmark	"Some"	"Some"	...	200
France	"Some"	None	...	"Some"
West Germany	220	832	...	1,052
Japan	60	170	240	470
Netherlands	3	62	...	65
United Kingdom	"Near" 100	"Some"	...	100

a. Only the Japanese exchange is open on Saturdays.
b. In addition to this figure, total intervention for the week includes a total of "over $100 million" on Monday, Tuesday, and Wednesday (29-31 January).

time move out of the Smithsonian band. Relatively small, but psychologically significant, US sales of Deutschemarks and Dutch guilders helped restore confidence. On 2 February in orderly trading the Bundesbank was forced to purchase $832 million in foreign exchange. Other central banks have also been forced to intervene in the market. Italy, Belgium, and Denmark have made substantial interventions to maintain the integrity of the EC currency band. Total foreign interventions in the week of 29 January - 3 February totaled more than $2 billion; the German Bundesbank purchased more than half of the week's total.

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Gold Price

21. Currency uncertainties have also forced the London free market gold price to a six-month high. There were reported Eurocurrency borrowings by speculators to finance gold purchases. Gold was fixed on 6 February in London at $68.80 per troy ounce. The increase of the gold price in Paris was greater than on other markets because of uncertainty about the outcome of the forthcoming French general elections. There is no indication that supply and basic demand factors have influenced the recent upsurge.

New Capital Controls

22. Bonn, in an effort to reduce the level of speculative capital inflows, strengthened its capital controls over the 2-4 February weekend. The measures adopted included requirements that Bundesbank permission be obtained by non-residents wishing to buy shares on West German stock markets, by West German firms wanting to borrow money abroad, and by local subsidiaries of foreign firms before their parent company can add to its investment. Importers are prohibited from obtaining special payment terms which add to the dollar inflow. Finally the cabinet will ask the West German parliament for authority to double the maximum rate of the **Bardepot**, the requirement that corporations make a non-interest bearing deposit with the Bundesbank on foreign borrowings. The current **Bardepot** rate is 50%.

23. The new controls add to a long list of controls recently instituted by industrial nations in an effort to inhibit speculation (see Table 3). These controls generally penalize increases in non-resident deposits and investments, limit overseas bank borrowing, and place restrictions on advance payment for exports. The experience with these controls has been mixed; while generally inhibiting capital movements, they have not been adequate to prevent speculation, particularly in otherwise open economies.

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Renewed Dollar Pressures

24. The new German controls and the Bundesbank's demonstrated willingness to intervene actively in the market helped calm the currency markets on Monday, 5 February, but only temporarily. Most currency markets were quiet throughout the day and the dollar closed mixed.

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25. The run on the mark resumed on 6 February, however, as traders apparently concluded that the West German controls would not be adequate. West German interventions reportedly amounted to $1.5 billion, practically all of which occurred before noon. Interventions were also reported in other European markets. Some of the uncertainty probably reflected rumors in US and European newspapers that US Treasury Secretary Shultz told West German Finance Minister Schmidt that the United States favored a Deutschemark float. This rumor was later denied.

26. The current currency uncertainties clearly have intensified pressures on Japan to revalue the yen. Even before Tokyo had to step up its dollar purchases in early February, high Japanese officials, probably including Prime Minister Tanaka, recognized that the size of the trade surplus made revaluation inevitable. Just this past weekend, the Governor of the Bank of Japan warned that yen revaluation could not be ruled out if the Japanese trade account surplus was not reduced. On 6 February, Tokyo also tightened its capital controls.